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MONETARY CONTROL IN THEORY AND PRACTICE

Malcolm Reid Fuller, B.B.A.
Boston University 1926

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MONETARY CONTROL IN THEORY AND PRACTICE

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INTRODUCTION

This study has been made at a time when the world is witnessing many changes in its monetary systems and the gold standard as such has been abandoned by most nations. However, gold still predominates in its influence despite the temporary breakdown of individual gold standard systems.

No effort has been made to make this a highly mathematical discussion but the subject has been treated as a problem of reasoning and logic based on history and the recent experience of nations with monetary controls.

MONETARY CONTROL IN THEORY AND PRACTICE

Chapter I

HISTORY OF CURRENCY

In the simple economy of primitive people, the exchange of goods was effected by means of barter. As the economic life of man became more involved, some common denominator or measuring stick of value was necessary in order to determine the relative value of goods. This usually took the form of some necessity of life such as cattle (food) and furs (clothing).

The next step in the evolution of a medium of exchange brought into use the precious metals, when they were available in sufficient quantities. These answered the need for a measure of value and at the same time were highly convenient to handle, so that they achieved a value not only as a commodity but as a medium of exchange.

Gold and silver have been the principal metals in such use. They are not easily destructible, have been available in sufficient quantities for use as money and yet are not so abundant as to lose their value. Any other metal that fulfilled the above qualifications could be used, but the fact that gold and silver have a high intrinsic value to all races and have been used as money for so many centuries adds to their general acceptability.

Many coins are in existence today that were used by the ancient Mongolians and Egyptians centuries before the birth of Christ, indicating that these people carried on extensive trade. The early Romans possessed a metallic currency based on the precious metals which aided them in carrying on a large foreign trade.* During the middle ages specie was scarce and Taussig# indicates that prices were very low reflecting the scarcity of the metal. Silver was the more common of the metals and in very general use. At that

* Principles of Money & Banking (3rd Edition) Page 4, R D Kilborne, Ph D

# Principles of Economics, Volume I, Page 253, F W Taussig

time there was considerable production of silver in Germany, Sweden, Bohemia and Spain but very little production of gold.

The development of the North and South American continents in the sixteenth and seventeenth centuries added greatly to the world's supply of precious metals. This increase was principally in silver, as gold existed and was produced in small quantities only.

The use of paper money on any considerable scale began during the latter part of the seventeenth century. The first paper money was issued by public or semi-public banks and found a ready circulation, as it was representative paper promising to pay in specie. "By the eighteenth century, paper substitutes for metallic money had become so familiar that the way was easy for the issue of inconvertible paper by public authorities."* The American Congress during the Revolution issued paper money in such large quantities, that it became practically

* Principles of Economics, Volume I, Page 305, F W Taussig

worthless, as did France during the French Revolution at the end of the eighteenth century. The Southern Confederacy resorted to inconvertible paper to finance their war operations, issuing it in large quantities till it became worthless. Other than this small section of the United States, no important country during the nineteenth century went so far to depreciate its currency that it became worthless.

About 1850 the production of precious metals was increased considerably due to the discovery of rich gold deposits in Australia and California.

The supply of gold available for monetary purposes in Europe more than doubled in the decade from 1850 to 1860 because of the discoveries in Australia and California, and this had a tremendous influence in changing the preference for metallic money from silver to gold. In the Western World silver was displaced to a large ex-

tent by gold,and the silver flowed to the Orient where it has been largely lost to world trade. Another tremendous increase in the production of gold took place in the period from 1890 to 1910. During this period silver was completely displaced for monetary use in the Western countries, gold being the standard of payment in all but the Orient. Silver's only monetary use was as a subsidiary currency.

Since the beginning of the twentieth century, improved mining processes have made available large quantities of gold from low grade ore that could not be profitably mined prior to that time. At the present time production is characterized by steadiness, which is increasing world supply but slowly on a percentage basis, and new discoveries have been irregular and of small consequences.

Chapter II

TYPES OF CURRENCY

There are innumerable types and kinds of currency both in metallic and paper forms. For everyday transactions paper has largely supplanted metallic coins, other than the subsidiary coinage for small transactions which is a part of the financial system of most civilized countries. There are two principal types of paper currency, namely, convertible and inconvertible. Convertible paper, which is redeemable in specie and backed 100% by specie, is merely representative paper and its use involves no intricate problem of volume, or control and regulation which characterizes most other forms of paper money. It need not be further discussed at this point for its problems are those of the metal that it represents and will be discussed in another chapter.

There is another form of paper money issued by governments which Moulton refers to as convertible fiduciary paper. This type of paper is exchangeable for specie but is not backed 100% by the specie. With the use of this currency there is possible a regulation of the quantity that can be issued, and control of volume becomes a problem of paramount importance.

There are several methods of controlling the volume of this type of currency:

a. Specie reserve must be fixed per cent of paper issued.
b. Fixed minimum quantity of gold as a reserve and paper variable.
c. Fixed volume of paper based on bonds, remainder based on 100% specie.
d. Paper based on real and personal wealth.

The above is partly based on methods outlined by Moulton.*

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* Financial Organization of Society, Page 99,
H G Moulton

Paper money came into use on a considerable scale in the latter part of the seventeenth century. At first it was issued by banks and represented bona fide promises to pay and thus found ready circulation. This use of paper money paved the way for later issues of paper money which were not promises to pay, namely, fiat money or inconvertible paper. The use of paper money had become a public habit and the way was open to public authorities to take advantage of the public acceptance of paper money and to issue fiat money. A strong government could give support to fiat money by laws, giving the money the status of legal tender and by making it good payment of public debts. However, distrust of the government issuing this money or dislike of paper money on the part of the people, may make its circulation slow and not acceptable to the people. It is also affected by the volume in which it is issued. History shows that when irredeemable paper is issued, the volume

is sure to increase and very often to the point that the paper becomes entirely worthless. This measure is most often resorted to in times of stress and scarcity of wealth as was the case during the periods of the American Revolution and the Civil War. Paper money tends to drive out metallic money and especially when the paper money is irredeemable. Writing of "overissue" Professor Taussig states, "Prices are steadily higher than they would be under a specie regime. When room for the paper is no longer made by the expulsion of specie, any added quantity causes a permanently higher level of prices. All the consequences of such a rise show themselves. Creditors lose, debtors gain. Prices of commodities rise faster than do ordinary wages, and faster than those incomes which are called "fixed", because strongly affected by custom. Business men make money. The rate of interest rises. An exhileration is felt in the industrial world, precisely as when prices rise from added supply of is sure to increase and very often to the point that the paper becomes entirely worthless. This measure is most often resorted to in times of stress and scarcity of wealth as was the case during the periods of the American Revolution and the Civil War. Paper money tends to drive out metallic money and especially when the paper money is irredeemable. Writing of "[illegible]" Professor Taussig states, "Prices are steadily higher than they would be under a specie regime. When room for the paper is no longer made by the expulsion of specie, any added quantity causes a permanently higher level of prices. All the consequences of such a rise show themselves. Creditors lose, debtors gain. Prices of commodities rise faster than do ordinary wages, and faster than those incomes which are called "fixed", because strongly affected by custom. Business men make money. The rate of interest rises. An exhilaration is felt in the industrial world, precisely as when prices rise from added supply of specie. The exhileration lasts as long, and only as long, as the process is kept up. It is the result not of higher prices, but of rising prices. When once the higher level is reached all round....the effect is like that of a drug; when the stimulus no longer acts, a reaction sets in."* There are countless examples of the overissue of paper (fiat) money, but only one notable example of the use of fiat money without serious depreciation. "The most notable is that of France in the War of 1870-71. The notes of the Bank of France (which were made virtually government paper, not exchangeable for specie) were issued in large amounts to aid the government in its financial exigiences during and after the great struggle. Yet the situation was handled with such caution and skill that only a slight specie premium appeared, lasting a short time only. The possible gain from a resort to paper was secured in this case without any serious drawback."# He later points out% that this money was made as a loan to the government,

*Principles of Economics Vol I,Page 309,F W Taussig
" " " " " " 315 "
% " " " " " " 356 "

and the government paid the bank interest on it and was to resume specie payment on it at a later date which it did. This made it practically representative paper as it was a promise to pay at a future date although the date was not definitely stated.

Chapter III

THEORY OF MONEY

During periods of stress and strain in an economic depression or during national crises brought on by war and impoverishment, there is a tendency to fall back on inflation of the national currency as a means of easing the strain. During periods of depression such as the world is experiencing at the present time, the temptation is present to inflate the currency in order to give a stimulus to business, for business does enjoy a degree of prosperity during any period of rising prices. But this is an artificial stimulant and if carried too far, will give a reaction that is decidedly unpleasant unless the business ills have been thoroughly cured during the depression. During the present depression there has been almost no resort to inflation, although much pressure has been brought to bear to bring it about. It is highly probable that the greatest restraining influ-

ence has been the recent experience of many European powers, when during the depression of 1921-24, they resorted to inflation, their currencies becoming almost worthless. From the close of the World War to July 1926 the French circulation increased 70%, while the German circulation increased 21,587,000,000% during the first five years after the War.* Similar inflation occurred in Belgium, Austria and Poland.

This inflation caused a highly unstable condition of industry once the stimulating affect of the first rises in prices was passed. Then followed the struggle to return to a sound money basis. This they were all successful in doing and it is unlikely that any of these countries wish to experience similar trials at the present time and their experience is constantly before the eyes of the other countries as an object lesson. Inflation and attendant money evils are laid at the door of the

*Principles of Money & Banking, Page 62, R D Kilborne

growth of capitalism, or perhaps more accurately industrialism, by many writers. Others attribute it to war and the burden of debt that it brings. The latter theory seems more logical and is substantiated by the history of the past seventy-five years.

Inflation has the effect of aiding the debtor groups who are able to ease their burdens by paying their debts with a depreciated currency that is easily available, while on the contrary it deprives the investing class of a part of its wealth due to a relatively fixed income on the part of this class of people. Keynes writes that "as a result of the war...and the monetary policy which has accompanied and followed it,... a large part of the real value of the possessions of the investing class..about ½ of their real value in England, 7/8 in France, 11/12 in Italy and virtually the whole in Germany, has been taken away."* He reasons, and soundly, that in order to draw savings into investments in the future, it will be necessary to have a stable standard of

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*Monetary Reform, Page 19, J M Keynes

value. Deflation is as a rule involuntary but occasionally it has been accomplished deliberately as a matter of policy, as in the case of Great Britain when she resumed gold payments and stabilized pound sterling at its old par of $4.86. In this case the practical working out of deflation has followed closely the lines that it should from a theoretical point of view. It protected the investing class which is predominant in England at the expense of the debtor group, and it did not in any way stimulate business although it did give a degree of stability.

This country is experiencing a period of involuntary deflation with all its attendant difficulties, but in spite of the hardships it brings, people as a whole are sold on the theory of sound money as best in the long run. It is no doubt acting as a purifier and adjuster of unsound conditions which were brought about by rapid expansion and easy prosperity, when people forgot real issues and each one thought that he could

gamble for a living, as attested by the unprecedented interest of the general public in stock market speculation during the late bull market.

The quantity theory of money in its simplest terms rests on the belief that prices vary in the same ratio as the quantity of money, that is the doubling of the quantity of money would double prices. Money in this connection must include bank credit that serves to effect a transfer of goods or complete a contract. It is affected, however, by many things such as the habits of people in regard to the amount of pocket money that they carry and the rapidity with which money is"turned over", the confidence of the public in the ultimate value of their currency and the extent to which available credit is utilized. The nearest approach to the heart of the propositions seems to be that the amount of money and credit that actively circulates does affect prices in a positive ratio.

The Theory of Purchasing Power Parity as developed by Professor Cassel rests on the belief that the "rate of exchange between the home currency and the foreign currency must tend in equilibrium to be the ratio between the purchasing powers of the foreign currency in the foreign country and of the home currency at home."* This applies to inconvertible currencies as the rate of exchange of gold currencies rests on the quantity of gold contained in each unit of currency.

Foreign exchange in the case of inconvertible currencies should be governed on the basis of the purchasing power parity, all other things being equal. As stated in the case of currencies based on gold, the foreign exchange ratio should be determined by the quantity of gold contained in the respective units of currency. In general it is true that the rate of exchange becomes more favorable to a country that is experiencing declining prices, and less favorable to

*Monetary Reform, Page 96, J M Keynes

a country going through a period of rising prices in relation to other countries. The rate of exchange is also subject to seasonal variations, due to irregular volume of international trade at various times of the year. Prior to the war these seasonal variations were usually cared for by short-term credits transferred from one center to another, and this service could be rendered inexpensively and with little risk when all currencies were convertible into specie. Since the war, however, these short-term credits are not easily obtainable and as a result large movements of gold are necessary for the settlement of debts that were formerly settled by means of credits advanced for this purpose. The use of gold in the settlement of debts is a costly and inefficient method and a stability of exchange would tend to lessen the need of gold in the settlement of international balances. When means are available in large and well organized centers of finance, it will be possible to lessen the

risk of carrying on foreign trade by the use of the forward market in exchange for making a present contract for a future purchase of foreign exchange, and in this way the uncertainty of future transactions is lessened.

Chapter IV

MONETARY SYSTEMS

Bimetallism -

Bimetallism as it is now known, or is advocated, allows the free and unlimited coinage of both gold and silver. If the coinage of either metal is limited, as was the case in the United States from 1879-1900, a country is not on a true bimetallic standard but is on a "limping" standard, so-called.* The two metals in this system of coinage are interchangeable at a fixed ratio set by law and both are full legal tender.

Bimetallism was but a step in the evolution of currencies. Although for many centuries past both gold and silver have been freely coined, it was not until the nineteenth century that the value of each metal was given a fixed ratio of value to the other. This change was made as a matter of convenience so that prices need not be quoted in two currencies, that is, a gold price and a

*Principles of Money & Banking, Page 29, R D Kilborne

silver price. The complete double standard had a given weight of silver equal in payment of debt to a fixed weight in gold. The ratio was usually about sixteen parts of silver to one of gold. Experience with this standard proved that the cheaper metal drove out the dearer one, for the reason that people hoarded the more valuable metal and paid their bills with the cheaper. This in a few words tells exactly why the complete double standard can never be successful. Many of its advocates are self-seeking politicians who spread this doctrine in order to obtain votes in sections of the country where silver is mined.

However, silver as a subsidiary coinage can be an important adjunct to the general currency system as it is in this country. Its value in this case is equal to gold coinage for all practical purposes in that it will be redeemed in full legal tender. Its value so given is greater than its market value as a metal so

that there is no tendency to melt it down or hoard it. There is no free coinage of the metal and it is purchased for this use by the United States on the open market. The margin of worth between the metallic value of the subsidiary coinage and its face or legal tender value is termed seigniorage and represents a profit to the government issuing it.*

Moulton# points out that the United States in the passage of its first coinage law in 1792 allowed for a definite ratio of silver to gold, free coinage of both metals and full legal tender for both. In practice silver, the cheaper metal, was presented for coinage and gold was used for bullion in international exchange or hoarded so that we were practically on the silver standard. Much gold also found its way to France where the coinage ratio was more favorable. This condition was unchanged until 1834 when the ratio was changed to make gold overvalued at the mint and as a result silver was

*Banking Principles & Practice,Page 12,R B Westerfield
#Financial Organization,Page 74, H G Moulton

replaced. This continued until 1861 when the United States entered the "greenback" era of irredeemable paper currency. Resumption of specie payments did not return until 1879 when we returned nominally to a bimetallic standard but in practice the coinage of silver was limited. The Gold Standard Act was not passed until 1900, at which time gold became the single standard of value.

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Silver -

For many centuries the world was nominally on a double standard of coinage, but actually it was on the silver standard due to the operation of the so-called Gresham's Law. Silver being the more plentiful of the two precious metals was cheaper and therefore offered for coinage. Gold by comparison was scarce and consequently the dearer of the metals.

Silver was relatively stable in value and was a satisfactory medium of exchange, production was steady and the available supply sufficient for the world's monetary needs.

England was the first nation to abandon silver and establish the single gold standard in 1816. By this act she relegated silver to the minor role of subsidiary coinage.

Silver owes its dethronement to the favorable experience of England with the single gold standard and the subsequent discoveries of gold which greatly increased the world's supply.

During the middle of the nineteenth century the leading countries of the world gradually changed to the single gold standard. As gold displaced silver the latter metal flowed into the Orient where it has since held sway. Any current discussion of the silver standard would necessitate an intensive study of Far Eastern monetary conditions which has not been attempted. It is agreed, however, that the present extremely low price of silver on world markets is a serious threat to the development of the Orient and to its present prosperity. A raising of silver prices would be a large factor in bringing back this section as a world market. Nevertheless, it does not seem probable that with the tremendous increase in silver production during the twentieth century that the price of silver will rise during the present generation.

The price of silver declined from "a high of 60.6 cents per fine ounce in 1928 to 25.72 cents in February 1931, a new low price for all time."* This puts India, China, and Mexico who is on a

*Principles of Money & Banking,Page 39,R D Kilborne

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The price of silver declined from a high of 60.6 cents per fine ounce in 1928 to 25.75 cents in February 1931, a new low point for all time.* This puts India, China, and Mexico [illegible] on a modified silver basis, at a disadvantage when engaging in trade with the remainder of the countries. It takes more silver dollars to purchase goods abroad than formerly, and the payment of debts to gold standard countries, or countries whose measure of value is gold, becomes irksome.

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*Principles of Money & Banking, Page 26, R D Kilborne

The foreign exchange rates of these silver standard countries fluctuates in about the same ratio as the value of silver as a metal when quoted in terms of gold standard currencies.#

The only apparent solution is the abandonment of silver for monetary purposes in the Orient and the adoption of some form of the gold standard in order to raise their purchasing power. Some advocate the remonetization of silver,or even bimetallism,but the increased use of silver which could be brought about through these various plans would have little

#Principles of Money & Banking,Page 42,R D Kilborne modified silver basis, at a disadvantage when engaging in trade with the remainder of the countries. It takes more silver dollars to purchase goods abroad than formerly, and the payment of debts to gold standard countries, or countries whose measure of value is gold, becomes irksome.

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Principles of Money & Banking, Page 49, H. G. Gibbons effect in raising the value of silver in relation to gold. The production of newly mined silver increased from "173,000,000 ounces in 1920 to 261,000,000 ounces in 1930."

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*Principles of Money & Banking, Page 40, R D Kilborne

Gold -

The use of gold for monetary purposes as already stated is almost as old as recorded history but until the nineteenth century it occupied a comparatively minor position owing to the greater availability of silver.

The gold standard in its present form was first adopted by Great Britain in 1816, but it was not until the discovery of rich gold deposits after 1840 that the available supply of this metal was sufficient to satisfy monetary requirements of the Western World. In the decade from 1851-1860, the average yearly production of gold was four times greater than that decade immediately preceding it and ten times greater than the decade from 1831-1840 only twenty years earlier. As gold became more plentiful, it rapidly assumed monetary leadership which it still holds despite the fact that the largest part of the world has abandoned redemption of gold. How-

ever, the worth of national currencies is still largely judged by the wealth of the national gold stock. The nations that have abandoned the gold standard are scrambling madly in the money markets for gold in efforts to build up their gold stocks. This fact would surely seem consistent with the belief that these nations will return to the gold standard whenever they find that they have sufficient reserves to insure redemption of their currency in gold.

The gold standard as it existed prior to the World War was characterized by the free and unlimited coinage of gold, the redemption of currency on demand and a sole legal tender status. The operation of these rules of the game, so-called, was unhampered by legal restrictions and this period was characterized by a relative stability of prices.

The gold standard of the post-war period has been an entirely different standard than

that maintained prior to the War. Specie in circulation has become a rarity, it having become the custom of the banks to hold all the gold possible in reserve. Some nations have redeemed their currencies in bullion only (France) as a means of keeping gold coinage from circulating. The bullion is suitable for settlement of international balances but hardly practical for domestic transactions. This has had the effect of concentrating gold in vaults of central banks and accustoming people to the use of paper money. The gold bullion standard is being seriously considered for adoption in the United States to replace the gold specie standard.

By the Gold Standard Act of 1900 the United States adopted the single gold standard which has endured until the present time with the exception of a few "gold holidays". At this time a gold fund was established to guar-

antee redemption of our greenback currency. There followed a period of prosperity and large profits. In 1907 there was a monetary crisis due to faulty control of the bank-note issue. In many states legal bank holidays were declared and most banks suspended specie payment. This led to plans for a central bank. At the same time the Aldrich-Vreeland Act of 1908 was passed to provide for an emergency issue of bank notes to enable the banks to liquidate their deposits. This Act was extended to 1914. In that year the banking system was subject to another financial strain and this emergency currency probably prevented a panic.* This currency was subject to a tax that brought its rapid contraction when it was no longer needed. In the latter part of 1914 the Federal Reserve System was functioning and with it came the issue of the Federal Reserve notes that have since become the most important form of bank notes in circulation as indicated by the fol-

*Principles of Money & Banking,Page 184,R D Kilborne

lowing chart:*

VOLUME OF FEDERAL RESERVE NOTE CIRCULATION IN RELATION TO TOTAL MONEY IN CIRCULATION

June 30.	Federal Reserve Notes	Total Money in Circulation
1921	$2,599,598	$4,910,993
1922	2,138,715	4,463,172
1923	2,234,660	4,823,275
1924	1,843,106	4,849,307
1925	1,636,108	4,815,208
1926	1,679,407	4,885,266
1927	1,702,843	4,851,322
1928	1,626,433	4,796,626
1929	1,692,721	4,746,297
1930	1,402,066	4,521,988

These figures show that in the decade 1920-1930 the value of Federal Reserve notes in circulation constituted from one third to one half of all the currency in circulation including actual gold specie and subsidiary coins.

The gold holdings of the United States increased tremendously during the period of

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*Principles of Banking & Finance,Page 297,G W Edwards

the World War. "The amount of our gold holdings increased by about 50% during 1915, 1916 and 1917."* In spite of our huge gold resources which amounted to about one third of the world's monetary supply, in 1917 the Secretary of the Treasury declared an embargo on gold which combined with an unwillingness to redeem our currency in gold constituted a temporary departure from the gold standard. The foreign exchange value of our currency was thereby lowered. This abandonment of the gold standard was against the wishes of the Federal Reserve Board but was no doubt considered a necessary evil of the war period. Since the War we have maintained the integrity of the gold standard until the crisis of 1933 which is discussed in the chapter entitled Recent Events.

*Principles of Money & Banking, Page 187, R D Kilborne

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*Principles of Money & Banking, page 137, H G Kilbourne

The Gold Exchange Standard -

One of the outstanding characteristics of monetary history since the War has been the widespread adoption of the gold exchange standard by countries not possessing sufficient gold or wealth to maintain an independent gold standard system. It is to be regretted that this system has suffered a severe setback because of the unsettled economic conditions of the past two years.

The essentials of this system have been concisely outlined by Kilborne. "The conditions necessary for the gold exchange standard are therefore, first, a cessation of the free coinage of silver; second, the establishment of a gold reserve at home or abroad or both, with the sale of drafts on these gold reserves at a rate as low as the cost of exporting or importing the gold; and finally, the retirement or expansion of the native currency when drafts are sold or cashed."

*Principles of Money & Banking,Page 48,R D Kilborne

This is a highly efficient and economic system that is an aid to the weaker nations in maintaining a stable domestic currency, and at the same time creates a stable foreign exchange with other gold standard or gold exchange standard nations. Under this system a nation can maintain a paper or silver standard without undergoing the economic readjustments that would be necessary with a change to the true gold standard, assuming that a conversion were possible. It also economizes existing monetary gold stocks, for a small gold fund plus foreign exchange or actual currency of gold standard countries can be set up to insure the successful operation of the plan. Prices in nations operating with a gold exchange standard show a uniformity parelleling prices in gold standard countries which tends to stabilize the world price level.

The chief disadvantage of this gold exchange standard lies in the strain on the great finan-

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The chief disadvantage of this gold exchange standard lies in the strain on the great financial centers of the world during periods of unsettled financial conditions. New York City and London were the centers upon which the world depended for maintenance of this system. It was in these two cities that the gold balances of the nations on the gold exchange standard were lodged. The international banking crisis of 1931 brought withdrawals of these balances and this was a contributary cause to the abandonment of the gold standard by Great Britain and brought the United States close to a similar condition. The liability of London, due to gold balances maintained there by other nations and sterling bills held by these same nations, was 254,000,000 pounds in March 1931, and similar factors were responsible for a large liability on the part of New York City estimated at $2,000,000,000 in 1930.*

The suspension of gold payments by Great Britain in 1931 and by the United States in 1933

*Principles of Money & Banking,Page 54,R D Kilborne

has eliminated the gold exchange standard for the present but it is hoped that with the return of "normal" conditions the standard will once more take its place as a counterpart of the true gold standard system. An international central bank as outlined in the Conclusions should eliminate the chief disadvantage of this system.

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Paper Standard and Greenbacks -

Paper standards of currency in a strict sense are those that are inconvertible. They constitute issues of what is generally termed fiat money. However, paper standards in practice may be of a higher order than would be implied from the use of the term fiat money.

There are several reasons for this. Nations who are now on a paper (inconvertible) standard are able to maintain their currencies with a relatively stable value because of the fact that gold is still held by their central banks and they are purchasing more gold whenever possible. Gold then is still a measure of value for their currencies although they are not redeemable at present. Stability of currencies is also maintained by the fact that much of the currency is based on forms of wealth other than gold, such as commercial paper, government bonds or similar assets. There is also the possibility that specie payments will be resumed

within a reasonable length of time. For the reasons outlined, paper standard currency at the present time is functioning in a reasonably efficient manner with only minor fluctuations in value. There is no doubt that this degree of stability is due to value behind the currency including gold stocks in reserve and hope of ultimate redemption.

The paper currency as discussed above is not to be confused with purely printing press money that is issued with no hope of ultimate redemption as was true in Germany ten years ago. This debacle is too recent to be disregarded by the nations and to date has been a prime factor in preventing similar monetary experience during the present depression.

There is, however, the ever present danger to nations whose currency is not anchored to gold, that mounting governmental deficits will ultimately bring issues of so-called printing

press money. Cooperation among the nations to bring about an early return of the gold standard is the only certain way of avoiding violent inflation in the next few years.

In the monetary history of the United States one of the most interesting periods was from 1862-1879 when the nation was on an irredeemable paper standard. In the early period of the Civil War the country was in a poor financial condition. The government was facing a deficit, an effort to float a large loan had failed and the banks had suspended specie payments. Two methods of financing were open to the government in the form of increased taxes or issuing of irredeemable currency. The latter course was chosen and in 1862, $150,000,000 of irredeemable paper money was issued. This was followed by other issues of paper money which brought inflation in the form of higher prices, increased cost of gold for international trade and increased

cost of financing the war. Professor W C Mitchell estimates that the issuance of greenbacks in the place of metallic or redeemable currency increased the cost of the war approximately one half billion dollars.*

These greenbacks drove the hard money from circulation and gold was traded as a commodity for use in foreign trade. In July 1864 gold cost $285.00 in greenbacks which was the highest price reached,# reflecting a depreciation of approximately one third in the gold value of the dollar.

This gold value of the greenbacks depended on several factors such as "the number of notes outstanding, the war news, the condition of the Treasury, the ability of the government to borrow and changes in the officials of the Treasury Department."%

Commodity prices rose rapidly after 1862 reflecting the increase in the currency issue and

*Principles of Money & Banking,Page 174,R D Kilborne
" " " " " " 171, "
% " " " " " " 171, "

instability of paper currency. The index of wholesale prices rose from 103 in 1862 to 185 in 1865* which year marked the end of the Civil War. Prices tended to taper off from 1865 to 1879 when specie payments were resumed.

After 1865 an effort was made to contract the currency but it was abandoned in 1868.# In this period of contraction, prices did slowly fall and conversely they rose slightly after 1868 when efforts to contract the currency were abandoned. However, in 1870 falling prices set in again and this tendency continued for the balance of this paper standard period.

In 1875 Congress passed a Resumption Act which set January 1, 1879, as the date for resumption of specie payments. In anticipation of this the gold reserve was gradually increased until 1879 when $133,000,000 in gold was available as against a greenback circulation of $346,681,016.

*Principles of Money & Banking,Page 171,R D Kilborne
#Banking Principles & Practice,Page 49, R B Westerfield

This issue of greenbacks is still in circulation and a gold reserve of $150,000,000 is maintained for its redemption.

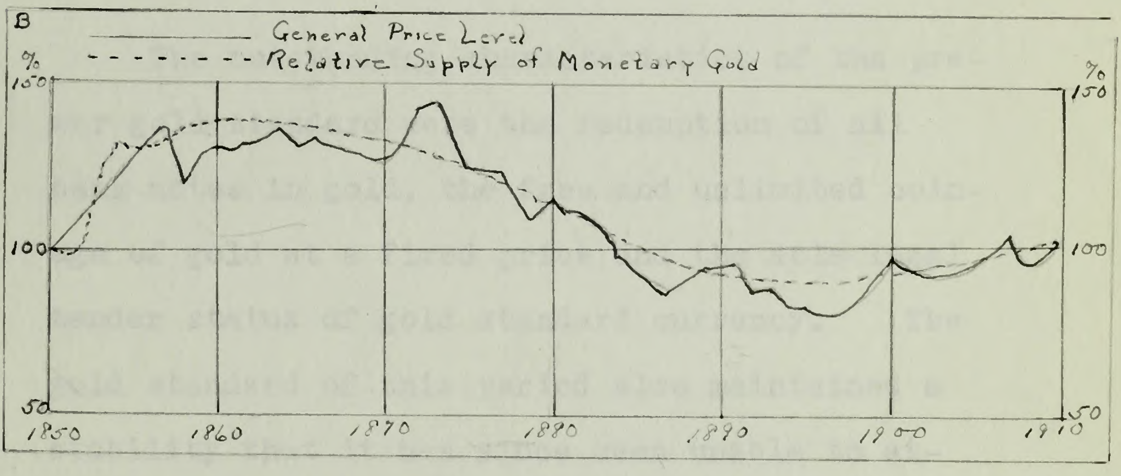
Chapter V

PRE-WAR DEVELOPMENTS

In the last half of the nineteenth century and up to the period of the World War the world was undergoing a tremendous growth of trade and industrialism. Is it coincidence that this growth paralleled the development of the single gold standard? Most economists agree that this expansion, particularly on an international scale, would not have been possible without a common standard of value such as furnished by the gold standard. One proof of the tremendous influence that such a standard of value exerts, is the almost complete stoppage of foreign trade that has resulted from the present breakdown of the international gold standard.

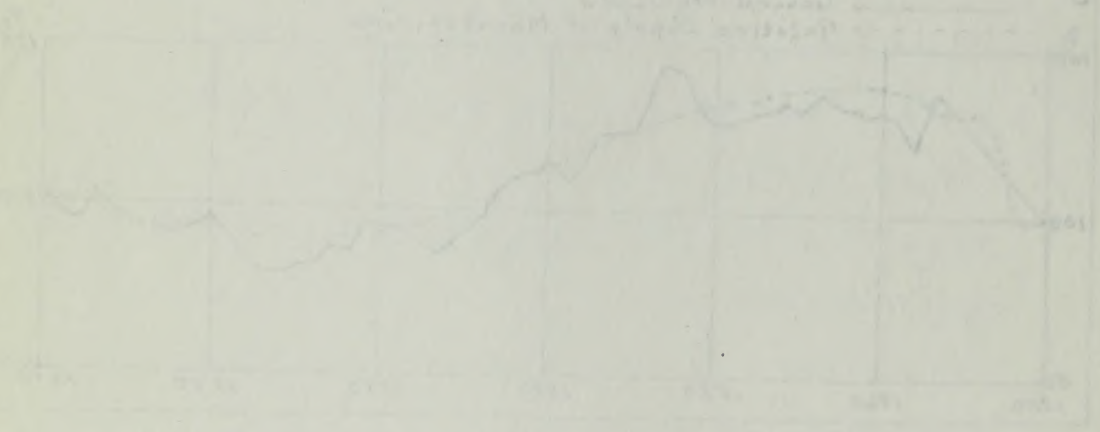
The establishment of the gold standard as already stated was made possible by the new discoveries of gold that made this metal sufficiently abundant to maintain currency systems

of the world. The various countries employed different methods of maintaining their currencies under the gold standard but from 1850 to 1910 there appears to have been a definite relation between the relative supply of monetary gold and the world price level as shown by the following chart.*



This indicates that the influence of gold supply on prices was direct and this can be attributed to the fact that the gold standard and money systems were simpler in operation than now. Gold as it entered the currency systems of the various countries was allowed to exert its influence on money and credit. However, during

Report of the Gold Delegation of the League of Nations, Page 31 of the world. The various countries employed different methods of maintaining their currencies under the gold standard but from 1850 to 1910 there appears to have been a definite relation between the relative supply of monetary gold and the world price level as shown by the following chart.



This indicates that the influence of gold supply on prices was direct and this can be attributed to the fact that the gold standard and money systems were simpler in operation than now. Gold as it entered the currency systems of the various countries was allowed to exert its influence on money and credit. However, during this period was laid the foundation for a gold standard to follow that would be a "managed" system, with gold being manipulated so as to prevent it from exerting its full effect. With increased economic activity came a more involved banking system, the use of credit instruments, foreign exchange and clearing facilities.*

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*Report of the Gold Delegation of the League of Nations, Page 11.

The outstanding characteristics of the pre-war gold standard were the redemption of all bank notes in gold, the free and unlimited coinage of gold at a fixed price and the sole legal tender status of gold standard currency. The gold standard of this period also maintained a stability that it has since been unable to attain. The characteristics as outlined above are actually fundamental economic laws of gold standard procedure that have not been adhered to in recent gold standard practice. Has the violation of these laws been a cause of the failure of the system to function in late years or are a new set of laws being evolved to meet the demands of the

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*Based partly on Paragraph 106 of the Report of the Gold Delegation of the League of Nations.

intricate financial system we have established? These possibilities are discussed in Chapter XII.

Chapter VI

WORLD WAR INFLUENCE

The period just prior to the World War witnessed an intense competition for control of the available supplies of gold, chiefly among the nations of Western Europe who must have known that war was imminent. This caused gold to be relatively scarce and acted as a depressant on prices.

At the outbreak of the War the United States was called upon for large payments of gold as the warring nations needing it to carry on,demanded gold for all balances held in this country. Ordinarily these maturing obligations would have been cared for by an advance of credits, probably in London. The War made this impossible and it was necessary to pool gold resources in this country in order to effect payments which were made through Ottawa instead of shipping the specie to London, owing to the uncertainty and hazards of transatlantic shipping.*

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*Chase Economic Bulletin - The Gold Standard & the American Gold Tradition, Page 8

As the War continued, the warring nations rapidly exhausted their gold resources in payment of supplies and materials. This necessitated abandonment of the gold standard in the nations affected and when payment in specie was no longer possible, these nations found that they were dependent on credit advanced by neutral nations, but chiefly by the United States. At the period just prior to the entry of the United States into the War, not only the specie but the credit of the Allies was nearly exhausted. The first service rendered by the United States was the advancement of credit, mostly in the form of balances set up in our banks upon which the Allies could draw. These loans were intergovernmental and by the end of the War period amounted to seven billions of dollars. After the armistice the United States advanced additional credits of three billions of dollars making a total debt due to the Government of the United States of almost ten and one half billions of dollars.

It is this tremendous burden of debt that has produced such a terrific strain both on international relations and international exchange in the past decade. The chief difficulty in the whole problem of the war debts as it relates to international exchange is, that this debt consisted mostly of credits made available in this country that were used to purchase supplies not only in the United States but elsewhere. In this way the result of this loan was the receipt by the debtors of goods and supplies rather than specie, whereas payment at the present time has to be made largely in specie owing to the high tariff wall built about the United States. We are a creditor nation on a large scale and full payment of these debts can never be made in specie. It is essential that provision be made for payment in goods or we must abandon hope of collection.

As previously stated the warring nations of Central and Western Europe were forced to abandon the gold standard in an effort to preserve their

gold stocks. This meant that these countries were on an inconvertible paper standard. Although large quantities of paper money were issued and prices rose sharply, there was no breakdown in the internal finances of the various nations, due largely to the fact that the people were fired with a patriotic fervor and were willing to accept paper money as a medium of exchange with but little question.

This habit of using and accepting paper money became so commonplace in the minds of the people, that its continued use after the War caused no lack of confidence. Gold continued as the standard of international value but currency was irredeemable. This condition might have continued indefinitely, but owing to the strain on governmental finance due to large war incurred indebtedness, the temptation came to the Central European nations to inflate their currencies as a means of paying their internal debt. This inflation came in the period

from 1921 to 1925. In Germany it continued until the currency was worthless and it became imperative to have a sound currency to replace the old.

France and Italy both tried inflation as a means of relieving internal debt, and both were forced to return their currencies to the gold standard although stabilized at a new low level more nearly in line with their national resources. England did not indulge in inflation but, nevertheless, found it advantageous to return to gold and chose the difficult path of deflation, pegging the pound sterling to gold at the pre-war level.

During the period of the War, the nations pegged their foreign exchanges one in relation to the other, which was a war-time emergency act that could not be successfully carried out under any other condition. This tended to stabilize both international finance and internal price levels.

Chapter VII

THE POST-WAR DILEMMA

The World War has left us a most varied heritage, of which but little is good and much is bad. Of the bad, the worst heritage from an economic viewpoint is the saddle of international debts and reparations which have thrown an unnatural strain on the nations individually and on international exchange in general. Those nations that emerged from the conflict as debtor nations have been forced to tax their people to raise funds for payment of their external debts, and then international exchange has had to bear the burden of making transfer of the payment possible either in goods or bullion.

The problem of internal taxation brought on by these conditions resulted in unbalanced budgets of the national governments until the course of least resistance was to inflate the currency. This tendency to inflate was further encouraged

by the general lowering of the price levels which set in about 1920. As the level of prices became lower, the burden of debts became greater. Most of the nations of Western Europe with the notable exception of England, rapidly inflated their currencies. Germany whose burden was the heaviest went so far as to depreciate the mark to the point where it became worthless. This action meant repudiation of all debts except those payable in gold. A new gold mark was then created at a ratio to the old currency of a trillion to one. Any medium of exchange, other than one based on tangible wealth, would have been unacceptable to a public whose faith in irredeemable money had been shattered. The French franc did not sink to the levels of the German mark but it did drop to about 20% of its pre-war purchasing power and was finally stabilized in 1926 at a gold value of $.0392.

These countries found that as a result of inflation, they were forced to return to a sound money basis to get their economic systems in work-by the general lowering of the price levels which set in about 1920. As the level of prices became lower, the burden of debts became greater. Most of the nations of Western Europe with the notable exception of England, mildly inflated their currencies. Germany whose burden was the heaviest went so far as to depreciate the mark to the point where it became worthless. This action meant repudiation of all debts except those payable in gold. A new gold mark was then created at a ratio to the old currency of a trillion to one. Any medium of exchange, other than one based on tangible wealth, would have been unacceptable to a public whose faith in irredeemable money had been shattered. The French franc did not sink to the levels of the German mark but it did drop to about 20% of its pre-war purchasing power and was finally stabilized in 1928 at a gold value of $.0392.

These countries found that as a result of inflation, they were forced to return to a sound money basis to get their economic systems in a staing order again. This period of inflation in Europe has resulted in the impoverishment of the middle class while the working class as a whole has somewhat bettered its position, wages remaining more fixed than was the case prior to the War and many social benefits being available through government patronage that were previously unknown.

One outstanding characteristic of the post-war period has been an intensive nationalism, perhaps on a greater scale than the world has ever before witnessed. Each nation has desired to become a complete and self-sufficient economic unit. Countries naturally inclined to agriculture have fostered industrial development in every way possible but principally by means of protective tariffs which have brought the leading countries of the world into a great scramble for markets. This has tended to hamper international trade. This nationalism has also manifested itself in a desire on the part of most countries to hoard their gold or to conserve it

within their own borders. There have been unprecedented attempts to control the flow of this metal by means of tariffs, embargoes, and other restrictions. These tariffs and restrictions have tended to bring a flow of gold to the creditor nations, for the free flow of goods to these creditor nations in payment of debts owed to them was not possible for the reasons just mentioned. Consequently we have witnessed an unprecedented transfer of gold to the creditor group, principally to the United States and France, but in a lesser degree the same is true of Holland, Belgium, Poland and Switzerland. (England will be treated later.) The United States was the largest creditor and received the largest amounts of gold. A workable balance of international payments was possible as long as we made capital loans abroad to compensate for gold balances being transferred here. It is a fundamental economic law that all debts must ultimately be paid for in goods, services or money (gold), but a country that is such a large

creditor as the United States will never be able to demand payment in specie without throwing international finance into chaos. This country must accept payment in goods or resign itself to the fact that these debts are largely uncollectible.

As the nations have made every effort possible to industrialize, they have unwittingly become increasingly interdependent upon each other for raw materials, markets and stability of exchange. This new era of industrialism needs as its very basis stabilized currencies. There must be a medium of exchange which can be depended on to have a relatively stable value or there can be no confidence in future planning which is essential for progress and growth.

In the same way that a currency within a nation must have stability, so it is essential to international trade that foreign exchange have stability. The most successful way that the world has yet found rests in the gold standard, and so about 1925 the countries of Europe struggled back creditor as the United States will never be able to demand payment in specie without throwing international finances into chaos. This country must accept payment in goods or resign itself to the fact that these debts are largely uncollectible.

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In the same way that a currency within a nation must have stability, so it is essential to international trade that foreign exchanges have stability. The most successful way that the world has yet found rests in the gold standard, and so about 1925 the countries of Europe stabilized their onto the gold standard. Under these conditions, international trade flourished and there was a tremendous increase in the wealth of nations. Trouble, however, was brewing due to the fact that although the various nations of the world were back on gold, they were not permitting the standard to work unhampered. The countries to whom gold flowed tended to "sterilize" a part or the whole of what they received so that its effect would not make itself felt on the internal price level, which is the automatic check that made the gold standard work so happily during the period prior to the World War. The automatic adjustments that were characteristic of the gold standard have been missing and when the cumulative effect of the "sterilization" was felt, international trade was seriously hampered. This has certainly been one of the major problems of the present depression.

The creditor nations have attempted to avoid the effect of accumulating gold within their borders but in the end this has brought about a malonto the gold standard. Under these conditions, international trade flourished and there was a tremendous increase in the wealth of nations. Trouble, however, was brewing due to the fact that although the various nations of the world were back on gold, they were not permitting the standard to work unhampered. The countries to whom gold flowed tended to "sterilize" a part or the whole of what they received so that its effect could not make itself felt on the internal price level, which is the automatic check that made the gold standard work so smoothly during the period prior to the World War. The automatic adjustments that were characteristic of the gold standard have been missing and when the cumulative effect of the "sterilization" was felt, international trade was seriously hampered. This has certainly been one of the major problems of the present depression.

The creditor nations have attempted to avoid the effect of accumulating gold within their borders but in the end this has brought about a maldistribution of gold so that the United States and France hold a very large part of the world's gold supply. Gold has become internationally scarce, therefore high, and prices have conversely been depressed. World trade has been stagnated and most countries have been driven from the gold standard. International debts have become almost uncollectible due to scarcity of bullion available to debtors and high tariffs surrounding the creditor nations.

If we could have a normal working of the gold standard without any artificial controls, the tremendous burden of debts as between countries would be considerably lessened, for gold would tend to flow to the countries that were in a creditor position. This would raise their price level and tend to bring about an outflow of gold. Conversely, the debtor country would find itself with a depressed price level which would attract gold and in turn tend to raise prices again. For this reason it seems that the solution to the problem of stagnation in internation-

al trade is a free and unhampered gold standard plus freedom from high tariffs and other trade restrictions.

Chapter VIII

DIFFICULTIES OF THE FEDERAL RESERVE SYSTEM

The distinctive characteristic of the Federal Reserve Act passed in 1913 was the regional plan which provided that the country was to be divided into not less than eight and not more than twelve districts, each to have a "regional" bank. These banks are in contrast to central banks of other countries where one acts for the entire country. A single central bank would not have been feasible in the United States owing to the large area and the diversified interests of the various sections of the country. Another reason for creating regional banks was to decentralize financial control.

These district or regional banks are subscribed to by member banks including all national banks and those state institutions that are eligible and so inclined. They are bankers' banks and only deal directly with the public in

their open-market operations. The central authority for these banks is vested with the Federal Reserve Board whose function "is not to operate but rather to supervise and coordinate the system."* This Board consists of eight men as follows: the Secretary of the Treasury who is Chairman of the Board, the Comptroller of the Currency and six members who are appointed by the President for a term of ten years.

The general powers of the board are given by Edward's as follows:#

A. Confirmation of changes in rediscount rates as recommended by the various Federal Reserve banks.

B. Operation of the Gold Settlement Fund.

C. Right to suspend or remove any officer or director of a Federal Reserve bank.

D. Granting of special privileges to member banks.

E. Recommendations to Congress for any changes in the Act.

F. Publication of the monthly Federal Reserve Bulletin.

*Principles of Banking & Finance, Page 278, G W Edwards
" " " " " " 278, "

The most important of its powers is the right to approve, change or reject rediscount rates as initiated or proposed by any of the regional banks.

The regional banks have it in their power to rediscount commercial paper of the member banks and in return, the member banks receive currency or an increase in their deposit at the Federal Reserve bank with whom they are doing business. This commercial paper must meet certain definite requirements as determined by the Federal Reserve Board, the chief of which is that it must represent a non-speculative transaction and must mature within ninety days of the rediscount date. This rediscount then allows an expansion and contraction of currency to meet the legitimate demands of business. However, there have been factors at work during the past decade to weaken this automatic adjustment of the nation's currency, the most important being the increase in the issuance of gold certificates in the place of Federal Reserve notes. This change

has been brought about by the tremendous flow of gold to this country most of which has come into the vaults of the Federal Reserve banks, making it easy for them to issue gold certificates. This has been a potential danger as these certificates must be backed 100% by gold and are,therefore, wholly inelastic in comparison with the Federal Reserve notes. The extent to which this was taking place can be seen from the table on the following page. The danger first became real in 1931 when public confidence in our banks was weakened, due to the failure of many. During the year 1931, 2,298 banks suspended business involving deposits of approximately $1,692,000,000.*

This condition brought about a reversal of the Federal Reserve policy of issuing gold certificates,for the amount of these certificates in circulation declined $320,000,000# in the year ending August 31, 1932, and in the same period Federal Reserve notes increased $845,000,000.

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*Principles of Money & Banking,Page 464,R D Kilborne
#National City Bank of New York Letter for October 1932, Page 151

Money in Circulation, Classified by Kind, at the End of Each Fiscal Year from 1921-30

June 30	Gold Coin	Gold Certificates	Standard Silver Dollars	Silver Certificates	Treasury Notes ~~of~~ 1890	Subsidiary Silver	United States Notes	Federal Reserve Notes	Minor Coins	Federal Reserve Bank Notes	National Bank Notes	Total Money in Circulation
1921	$447,272	$200,582	$65,883	$158,843	$1,576	$235,295	$259,170	$2,599,598	$91,409	$129,942	$721,421	$4,910,993
1922	415,937	173,342	57,973	260,335	1,510	229,310	292,343	2.138,715	89,157	71,868	727,681	4.463,172
1923	464,181	386,456	57,262	364,258	1,460	247,307	302,749	2.234,660	93,897	19,969	711,076	4,823,275
1924	393,320	801,381	54,015	364,414	1,423	252,995	297,790	1,843,106	96,952	10,066	733,835	4,849,307
1925	402,297	1,004,823	54,289	382,780	1,387	262,009	282,578	1,636,108	100,307	6,921	681,709	4.815,208
1926	391,703	1,057,371	51,577	377,741	1,356	270,072	294,916	1,679,407	104,194	5,453	651,477	4,885,266
1927	384,957	1,007,075	48,717	375,798	1,327	275,605	292,205	1,702,843	108,132	4,606	650,057	4,851,322
1928	377,028	1,019,149	46.222	384,577	1,304	278,175	298,438	1,626,433	111,061	4.029	650,212	4,796,626
1929	368,488	934,994	40,684	387,073	1,283	284,226	262,188	1,692,721	115,210	3,616	652,812	4.746,297
1930	357,236	994,841	38,629	386,915	1,260	281,231	288,389	1,402,066	117,436	3,206	650,779	4.521,988

*Principles of Banking + Finance, Page 297, G. W. Edwards

The strain to which our monetary system was being subjected owing to the loss of public confidence in our banks was further increased by the hoarding of currency and large foreign withdrawals of gold. In February 1932 the passage of emergency legislation in the form of the Glass Steagall Bill was necessary to save our banking system from collapse. This bill allowed groups of five member banks to borrow on a promissory note, the proceeds to be loaned to any bank in need of assistance within the borrowing group. Provision was made for direct loans to a member bank but at a premium on the cost of rediscounting. It also provided that the collateral behind the Federal Reserve notes could include direct Government obligations in addition to gold and eligible paper.

The control of rediscount rates gives to the Federal Reserve banks a most important power in determining our national fiscal policies. The changes in these rates can be made to follow a natural course, merely reflecting scarcity or a-

bundance of credit, or on the other hand they can be arbitrarily controlled to check expansion or to encourage the use of credit during times of depression. Other factors may motivate a change as when in 1925 the Federal Reserve made available to the Bank of England $200,000,000 in credit at New York to enable England to return to the gold standard. In order to discourage the flow of gold to this country a policy of cheap money by means of low discount rates was deliberately pursued.

This set in motion expansion and inflation that later became unmanageable as reflected in the tremendous speculative increase in the price of securities up to 1929.

The discounting of commercial paper is a passive act on the part of the Reserve banks for no effort is made to buy up eligible paper. Control is exercised by means of encouraging or discouraging the use of the rediscount facilities through changes in the rediscount rate.

There is another powerful factor in aiding the Federal Reserve banks to pursue a definite fiscal policy when they wish to arbitrarily influence credit. This takes the form of so-called open-market operations. The purpose of these operations, however, is not solely to augment the use of rediscount rate changes and to influence credit, but to invest the surplus funds of the regional banks so that they can be operated profitably. The banks are permitted to buy and sell at will certain types of investments as listed.*

1. Agricultural credit obligations
2. Municipal warrants
3. Trade acceptances
4. Bankers' bills
5. United States Government securities.

The relative importance of these investments is indicated by the table given below:#

*Principles of Banking & Finance,Page 308,G W Edwards
" " " " " " 310, "

FEDERAL RESERVE BANKS --HOLDINGS OF SECURITIES PURCHASED IN THE OPEN MARKET, 1921-1930
(in thousand dollars)

End of Dec.	Agricultural Credit Obligations*	Municipal Warrants	Trade Acceptances	Bankers' Acceptances	U S Gov Obligations
1921	$	$379	$ 218	$145,045	$233,528
1922		39	1,178	270,944	436,155
1923		51	2,663	351,974	133,566
1924	2,050#		227	386,873	540,160
1925	3,205#		1,217	373,139	374,568
1926	2,500	121	1,258	379,728	314,820
1927	760	120	702	391,337	616,516
1928	9,825	60	537	488,532	228,064
1929	12,150	150		392,209	510,587
1930	6,300	843		363,844	729,467

*Includes Federal Intermediate Credit bank debentures & Federal Land bank bonds.
#Represents municipal warrants and Federal Intermediate Credit bank debentures.

This chart not only shows that the bulk of these holdings consist of bankers' acceptances and United States Government obligations, but also shows that there was a tremendous increase in holdings of Government obligations in 1930. This can probably be attributed to two factors; first the lessening of commercial paper being presented for rediscount,owing to the falling off in business activity which placed a surplus of funds at the

disposal of the Reserve banks for investment; and secondly, to the desire to bolster credit by means of open-market purchases.

In the early years of their existence the Federal Reserve banks indulged extensively in open-market operations. "In 1915, 48% and in 1916, 72% of the total investments of the Federal Reserve banks were secured through open-market operations. In 1917 and 1918 the purchases of paper in the open-market represented 12% and 16% of the total investment operations of the regional banks. From 1917 until about 1922, the demand of member banks for credit was so great that the regional banks were able to employ all their funds in rediscount operations. Since 1923, the open-market operations have been confined largely to the purchase of United States bonds and securities."*

Open-market operations have been resorted to extensively and frequently during the past three years to bolster credit and put money in circula-

*Principles of Money & Banking,Page 462,R D Kilborne

tion. Government bonds have been purchased in the open market and currency has been put into circulation thereby, but this has done little to alleviate poor business because powerful factors of adjustment are at work that can not be denied and this currency has found its way back to the banks or has remained in hoarding. However, under "normal" conditions the open-market operations have been effective both as a means of investing surplus funds and controlling credit.

The Federal Reserve Banking System has proven itself capable of exercising a tremendous influence over credit and currency. In spite of the temporary break-down of our banking system, the Federal Reserve banks should be more powerful in future control of monetary policies. The experience gained from the great strain through which they passed in March 1933, should be invaluable as an aid to future operation. One result of the acute crisis was to bring agitation for a unified commercial banking

system in this country. Within a few years it seems probable that all commercial banks will be compelled to affiliate with the Federal Reserve System.

The present trend in currency issue is towards central bank control. In some countries, as in Austria, the central bank has the sole right of issue, while in the United States and other countries the right of issue is extended to other banks. There is strong sentiment at the present time for revocation of currency issue rights to all but the Federal Reserve banks. This would tend to centralize control of currency and should make the management of our national financial system more effective.

Chapter IX

CONTROL OF CURRENCY
and
PRICE STABILIZATION PLANS

(A) Theories of J M Keynes

This brilliant English economist has written at great length on the subject of currency management. It is his contention that whether we like it or not, we have managed currency with us at present, even in countries that are tied up with the gold standard. This management or control is brought about by central banking policies in regard to paper currency and bank credit. He states, "The value of gold itself depends on the policy of the central banks."* Gold is sterilized arbitrarily by the central banks and they are able to control gold exports in the form of capital loans to other countries so that he believes that gold has lost its power of automatic adjustment of prices as between countries on the gold standard. However, in the present stage of world progress we

*Monetary Reform, Page 183, J M Keynes

are safer with the gold standard plus management, than with management without the gold standard. He recognizes that in theory we would be better off with proper management than with gold, and evidently believes that this is not unattainable for he states, "Regulation of standard of value is not essentially more difficult than many other objects of less social necessity which we attain successfully."* This argument is, however, not wholly logical for there is no agreement in the minds of the thinkers as to what constitutes proper regulation of currency. His theory, although not stated so exactly, seems to be that we are passing through a period of evolution in currencies, from a purely gold standard to a managed gold standard and eventually to a purely managed standard.

The United States Federal Reserve system constitutes in his opinion a managed system. Gold is sterilized at will and credit is strictly contolled as a matter of policy in regulating prices and business.

*Monetary Reform, Page 183, J M Keynes

In 1924 he brought forth the theory that central banks should aim to stabilize the commodity value of currency rather than its gold value and to effect the former by varying the gold value of the unit of currency. He further theorizes that the United States and Great Britain thus established could be the basis of a gold exchange standard for the rest of the world.* History has shown that for the five years following, the gold exchange standard was in very wide use and was based largely on the currencies of the United States and Great Britain, although these two nations did not vary the gold value of their currencies. This standard was entirely satisfactory and highly efficient as regards gold, until the break in world prices and loss of confidence in national currencies. This brought not only the breaking up of the gold exchange standard but the gold standard itself, for the gold supplies of the United States and Great Britain were subject to tremendous drain and to a point where Great Britain was forced to abandon the gold standard and the United States was barely able to maintain it.

*Monetary Reform, Page 220, J M Keynes

(B) Recent British Monetary Experience

Great Britain's present financial ills are largely traceable to 1925 when she returned to the gold standard at the old par which was to bring severe deflation and strain on the balance of payments. This step meant that they paid all of their debts in full at the sacrifice of their own people, particularly the working or debtor group. To ease the strain on the balance of payments, it was necessary either to lower money incomes, increase efficiency or do both. The lowering of money income was a difficult task owing to social benefits paid for by producers in the form of unemployment insurance. The effects of deflation were partially overcome but the bad effects were cumulative and combined with the cheap money policy pursued when pound sterling was not in a strong position, brought an ultimate collapse of the gold standard in 1931.

T. E. Gregory gives the following as reasons for aggravation of Great Britain's difficulties:*

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*Gold Standard & Its Future, Chap. III, T E Gregory

1. Stabilization of Belgian, French and Polish currencies at low levels.
2. Japanese competition in the Far East.
3. India boycott.
4. Stagnation in demand for textiles and coal.
5. Large foreign balances in Lond (potential danger).

He gives as the immediate cause of going off the gold standard an international banking panic induced partly by the Continental situation and partly by fear that it would react dangerously on the safety of the London banks.

He suggests that it would have been better to have pursued a policy of 'dear' money even at a sacrifice of part of the gold stock and to have suppressed publicity as to the future of sterling.

Prices in Great Britain since 1931 have risen to some extent which combined with the fall in gold prices elsewhere has made Great Britain's position more difficult. Payment of her external debts is more costly and the acquisition of new

gold expensive. But she has shown tremendous recuperative powers and has been steadily acquiring fresh gold. Part of this she has been able to gather because of the tremendous size of British investments abroad with interest regularly due. She has added a tariff on imports that has also helped her international position but possibly at the expense of her populace, forcing them to a lower standard of living.

A surprise source of gold has been India which has sold tremendous quantities to England because of the premium offered for it. The gold of India has an effect similar to an increase in the world's monetary gold supply for it had previously been hoarded and was an unknown quantity.

England's position as a creditor nation is certain to eventually bring about an accumulation of foreign balances. This will be particularly true when war debt payments are scaled down or cancelled. In this event an investment of her surplus will be essential and in order to lend

profitably, there must be borrowers who are seeking loans. Other things being equal a borrower will seek his loan in a currency that is stable so that the value of the loan at maturity can be definitely established at the time of borrowing. Under these conditions it is plainly evident that should the United States agree to lower war debt payments, an early return of Great Britain to the gold standard would be certain. London has long been an international financial centre and has enjoyed tremendous prestige as a result. To retain this business with its lucrative income, it is going to be necessary to return sterling to a fixed ratio with gold. The sterling bloc about which so much has been written has not materialized and it is doubtful that it will.

In England the banking system is highly unified and after departure from the gold standard in 1931, there was uniform action on the part of the banks to maintain a relatively stable price level which they have been successful in doing.

There has been no inflation of currency. One surprising feature of the trend of the internal price level has been its similarity to gold price levels in the United States and to a lesser extent to those of France.* Can this be attributed to the influence of sterling on gold prices or gold on sterling prices? It probably is the latter owing to the fact that gold is still the international measuring stick of value and that the world is undergoing a general lowering of the price level. "The London Economist price index based on 1927 as 100, shows the figure 60.4 for September 18, 1931, just before the suspension, and 60 for November 2, 1932."# Another factor is the Exchange Equalization Fund which has been used to maintain sterling in a relatively stable ratio to gold standard currencies. For this purpose Parliament made available to the British Treasury a fund of 150,000,000 pounds. The course of sterling exchange "has been marked by some eccentric movements which has indicated that it was now under control and then left to itself."%

*Boston Transcript 1/28/33, World's Central Banks Could Raise Price Level, F J Mahaney

#National City Bank of N Y Monthly Letter,Dec 1932 Page 187

%National City Bank of N Y Monthly Letter,Dec 1932 Page 188

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*Boston Transcript 1/28/33, World's Central Banks Could Raise Price Level, F J Mahoney
#National City Bank of N Y Monthly Letter, Dec 1932 Page 187
‡National City Bank of N Y Monthly Letter, Dec 1932 Page 188

This is an expensive plan for the fund must occasionally be renewed but it can be considered as a necessary evil for a paper standard country.

If gold prices could be raised, it would be a tremendous aid in restoring an international gold standard, for it would make it much easier for paper standard countries to return to the gold standard.

Great Britain has not obtained many of the benefits that were claimed for her at the time of leaving the gold standard, for her internal business has but slightly improved and exports have not boomed as it was predicted. Part of this is due to non-flexible cost within Great Britain which makes wages and other charges difficult to lower.

The countries that are off the gold standard such as England, buy gold as a means of stabilizing their foreign exchange which is an indicator of the degree to which they are dependent on gold. An Associated Press dispatch* from London on February 23, 1933, tells of

*The Boston Transcript, Feb 23,1933

Neville Chamberlain, the Chancellor of the Exchequer, explaining recent gold purchases by the Bank of England as being necessary to guard against wide fluctuations in sterling exchange. Here is shown their dependence on gold to aid in maintaining equilibrium of their exchange.

It is certain that when the debt burden is eased, gold prices are raised, or other favorable factors are present, Great Britain will return to the gold standard but probably at a level of about $3.45 for pound sterling.

(C) Theories of Gustave Cassel

It is Professor Gustave Cassel's (University of Stockholm) belief that it may be impossible to restore the gold standard as an international standard, and that it would not be at all desireable unless we reverted to what he calls the "rules of the game". He believes that gold is no longer an "acceptable standard of value for an international system of money."* Its restoration would entail "a great reduction in the value of gold, a radical redistribution of the world's gold reserves, the resumption of a systematic gold economising policy, cancellation of all claims on reparation and war debt payments, definite guarantees against the repetition of such extraordinary demands for gold as have occurred during the last few years, and, finally, restoration of a reasonable freedom of international trade and of international capital movements."#

He believes that the countries now off the gold standard should work together to set up a

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*Report of the Gold Delegation of the League of Nations Memorandum of Dissent, Page 74

#Report of the Gold Delegation of the League of Nations Memorandum of Dissent, Page 75

standard based on sterling so that some degree of stability can be maintained. From this experience he intimates that an acceptable standard may be evolved. These plans which he brought forth a year ago for the formation of a "sterling group" have been widely advocated since that time, and some progress has been made particularly as regards the relation of the Scandinavian currencies to sterling, and it is being urged that all the countries of the Empire join this group. Only recently several of the Empire countries abandoned gold, South Africa being the most recent, and these countries are stabilizing their exchange with sterling. The only notable exception is Canada and the action of the Canadian dollar on the foreign exchanges would indicate that it is generally believed that Canada will abandon the gold standard and join the sterling group. Opposed to this belief, however, is the strong financial tie between New York and Canada.

Last year in a series of Rhodes Memorial Lectures delivered at Oxford, Professor Cassel was very

outspoken against gold reserves being tied up in a definite ratio to note circulation. He stated that the countries on the gold standard should inflate their currencies. He explained that the United States and France had sterilized their surplus gold.

The opinions of Professor Cassel seem to be tinged with pro-British sentiments for the stipulations that he makes for a return to gold are essentially those that would be beneficial to England. Sweden since leaving the gold standard in September 1931 has been successful in maintaining a stable internal price structure.* This is a small homogeneous nation which enjoys the able economic leadership of such men as Professor Cassel. Their financial system is closely linked with that of Great Britain. Their gold holdings have been small amounting to only $64,000,000 in June 1931 at which time they possessed $76,000,000 in foreign exchange# mostly in sterling.

*Money & Prices & the Depression, W G Sutcliffe
#National City Bank of N Y Monthly Letter, Oct 1931

(D) Theories of E. E. Garrison

Elisha E. Garrison has written an extremely interesting volume entitled The Riddle of Economics and published in 1932. He deals at considerable length with the theory of money and principally with regard to its scientific issue.

He assumes a minimum average requirement for money volume and then theorizes as to what should govern the volume of money over and above these minimum requirements. This flexible portion of the money volume he refers to as marginal money. The control of the volume he believes should be in the hands of the central bank who would rediscount short-term commercial paper based on non-speculative exchanges of useful commodities, and the rediscount privilege should be limited to this type of paper exclusively.

This plan as he outlines it would eliminate support of speculation by the central bank. He does, however, point out that the tremendous increase in the use of the bank check makes it difficult to control speculation.*

"Gold", as he sees it, "is only one of the many elements in price determination. . . . banking

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* The Riddle of Economics by E. E. Garrison Page 95

methods employed are vastly more influential,.... issue banks . . .shall adopt the principle of basing the circulating medium upon a combination of public and private credit. . . .using a large proportion of the world's gold as a reserve rather in the military sense than in the money sense, as a means of strengthening the public credit of each nation with its own people, as well as with other nations."*

Garrison's plan for restriction of rediscount to non-speculative paper is sound but too limited to permit development and expansion of new industries. Recent experience in the United States has shown that the basis for currency issue should not be too restricted so that currency can be used in times of financial stress to replace shrinking bank deposits.

* The Riddle of Economics by E. E. Garrison Page 42

(E) Price Theories of Richard Whitney

Richard Whitney, President of the New York Stock Exchange, delivered an address before the Merchants' Association of New York on September 17, 1931, which has since been printed in pamphlet form under the title of Economic Law in Business. He discusses in a most able manner the theory of prices and their relation to business and finance. The speech traces our recent business and financial history from the time of the World War. He relates that there was strong sentiment to stabilize prosperous conditions that set in about 1925. Quoting his article, "Both government and private interests proceeded to peg or manipulate prices on the blithe assumption that they were thereby introducing 'order' into business by 'leveling off the hills and the valleys' of price fluctuations. They forgot that in most commodities the basic conditions of supply and demand were constantly changing, and that prices had of necessity to change with them."*

He treats of the attempt of Brazil to fix the price of coffee, Great Britain that of rubber,

*Economic Law in Business, Page 9, R Whitney

Canada wheat and of the Continental cartels in steel, iron and other products. In addition there were attempts by the "United States Government to stabilize prices of wheat, cotton and other agricultural products."*

Production, as he states, was unnaturally stimulated and the law of supply and demand was disregarded. "In the end, the over-stimulated production overwhelmed the world's markets and precipitated a violent readjustment in commodity prices which has borne world-wide depression in its wake."#

The same is true only on a larger scale of attempts to stabilize the general price level. Prices are looked upon as the cause of much of our grief as they always decline severely during a period of readjustment and are associated with the evils of the times, whereas they are merely an indicator that powerful factors are at work to correct our economic system. If stability of currency could be obtained (not stability of prices), then the governing factor

*Economic Law in Business, Page 9, R D Whitney
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of prices would be the law of supply and demand. If prices were allowed to seek their own level without such interferences as tariffs and attempts at price stabilization, they would act as an economic balance. Price stabilization in general acts as an offset to the law of supply and demand. In that way it brings about overproduction and overexpansion of capital equipment. The theory of attaining price stabilization is based on the premise that stabilization of prices is desireable. Would it not be more logical to work for a sound money system with expansion and contraction of the nation's currency as it was needed? Interest and discount rates should not be so controlled by central banks that they tend to offset price movements in either direction, but should resume their original function of reflecting scarcity or plentifulness of credit and allow the law of supply and demand to take its normal course. We have governmental control and interference in business, agriculture and banking at the demand of

organized minorities. Finance as well as business would be healthier with less of such interference and paternalism. The government should confine itself to guaranteeing the security of money. One of the chief virtues of gold as a backing for currency is the elimination of the necessity for too much governmental regulation.

(F) Theories of Irving Fisher

Professor Fisher is an advocate of the plan for a stabilized dollar. He would accomplish this by means of a gold dollar of varying weight and fixed purchasing power. The present gold value of the American dollar is 23.22 grains of pure gold. Under Fisher's plan this weight of gold would be varied with the rise and fall in prices. He would set up a commodity price index based on one hundred essential items of trade. As this index rose he would raise the weight of the gold dollar to offset the rise in commodity prices and conversely he would lower the weight of the gold dollar to offset a lowering of his price index. This adjustment would be monthly and would be limited to a change of 1% per month.

Assuming that a representative commodity price index could be compiled, it is doubtful that variations in the gold content of the dollar would be entirely effective in stabilizing prices for there are many factors of credit, currency turn over and supply of goods that must be consid-

ered. The operation of this plan would bring undesireable fluctuations in foreign exchange rates which would seriously affect our foreign trade.

The stabilized dollar would undoubtedly bring a degree of internal price stabilization but it is doubtful that the benefits so attained would be worth the sacrifices that this plan would entail.

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(G) Theories of T. E. Gregory

T. E. Gregory, a brilliant English economist, has written a volume on The Gold Standard and Its Future which gives a very complete picture of gold standard operation.

He cites the necessity for central bank cooperation among nations desiring to operate under the gold standard and he advocates abolishing minimum statutory reserve rates and the lowering of the gold content of the unit of currency.* The abolishing of minimum reserve requirements as he sees it, would free large quantities of gold that are now "immobilized". This combined with the lowering of the gold content of the unit of currency should bring about economies in the use of gold.

He further believes that if prices in gold standard countries were to rise, need of cooperation would be lessened and the return of paper standards to gold would be made easier.

*The Gold Standard & Its Future, Final Chapter, T E Gregory

He makes some interesting observations in regard to world chaos necessitating a return to the gold standard. "It is not in periods of general distress that a paper currency can be successfully managed."* This is a refreshing view point and is in contrast to most theorizing.

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*The Gold Standard & Its Future, Page 94, T E Gregory

Chapter X

THE WORLD'S GOLD SUPPLY

Much has been written on the adequacy or inadequacy of the world's monetary gold supply as well as the yearly production necessary to support natural increase and growth of trade. Cassel's studies are well known and widely quoted, particularly his theory that a yearly increase of 2.8%* in total gold supply is necessary to sustain prices and support credit if economic progress is to be maintained at the present pace. Kitchin has made similar studies with the result that he figures a 3.1% increase in monetary gold supply is necessary for stability of the general price level over any considerable length of time.

The total supply of monetary gold at the present time is approximately twelve billion dollars and production during the past year has been greatly accelerated due to lower costs of production and increased purchasing power of gold. The

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*The Functioning of the Gold Standard, Chap III, Section 6, Dr. F. Mlynarski

National City Bank of New York in its monthly letter presents some interesting statistics on gold stocks and production. Their table shows an annual increase in gold stocks from 1900-1929 of 5.8% and from 1929-1932 of 5%.* These figures would indicate an adequate increase in the world's supply. Gold production for the year 1932 at the mines was $494,000,000 which is a new high record. The best previous year was 1915 when $470,000,000 in gold was mined. In addition to this $220,000,000 in gold was released from India and China. After considering the $40,000,000 in gold absorbed for non-monetary purposes, the net gain to the existing monetary stock was 5.9%.#

The table on the following page shows some interesting trends in the accumulation of gold stocks.%

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*The National City Bank of N Y Monthly Letter Page 42, March 1933

#The National City Bank of N Y Monthly Letter Page 43, March 1933

%Table taken from National City Bank of N Y Monthly Letter Page 137, September 1932

GOLD RESERVES OF CENTRAL BANKS AND GOVERNMENTS
(In millions of dollars)

	1900 Dec 31	1913 Dec 31	1932 June
United States	511	1,290	3,610*
United Kingdom	139	165	663
France	451	679	3,218
Russia	365	872	349
Germany	119	279	198
Italy	78	265	298
Austria-Hungary	186	251	87#
Belgium	21	48	357
Netherlands	24	61	394
Switzerland	19	33	503
Sweden	10	27	55
Norway	7	12	40
Spain	68	92	435
Argentina		256	249
Japan	33	65	214
15 (17) Countries	2,031	4,395	10,670
30 Other Countries		538	776
45 (47) Countries		4,933	11,446

This table shows a large increase in gold stocks from 1900-1913 at a time when gold production was increasing yearly,but an even larger increase is shown in the period from 1913-1932 when gold production was falling off in volume. This can be accounted for by the tendency to hold gold coins in central bank vaults in contrast to the pre-war period when

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*Austria, Czechoslovakia, Hungary
#End of August, 1932

gold coins circulated freely. The large gold reserves of the United States and France are shown in contrast to the relatively small gold stock of the United Kingdom.

These studies may be of some theoretical value but from a practical view point they are overshadowed by the necessity of making available supplies of gold sufficiently elastic to care for normal growth of trade. The gold standard is certain to be the backbone of our international financial system for several generations at least, for if a paper standard in pure theory is admittedly superior, it should be recognized that the change from gold to paper, successfully managed, would be, at best a gradual evolution.

The present supply of monetary gold is entirely adequate if it is properly managed through international cooperation. It has also been shown that when gold through abnormal circumstances is in great demand, much gold which previously has

not been a part of the known monetary supply can be attracted to monetary use, as illustrated by the large sums of gold (estimated to be one quarter of a billion dollars) sold to London from India after England left the gold standard in 1931. Much gold that is now hoarded will be in circulation as money when financial stability is attained again.

Chapter XI

RECENT EVENTS

At the present time there are numerous restrictions on gold exports and in some cases by countries that are on the gold standard. This would certainly indicate that there has been a breakdown in the international balance of payments.

Business has been declining steadily since the summer of 1929 and this recession has been accompanied by an effort on the part of each country to protect home industries, principally by means of high tariffs which preclude payment of international debts in goods. A great strain has thereby been thrown on the monetary gold system of the world. To an increasing extent the payments of international balances have had to be made in gold. Gold has been shipped from one country to another at a rate never before equalled in history. As credits and loans were no longer

available to the debtor nations, doubt as to their ability to meet obligations was prevalent. It was this condition that led to the Austrian banking crisis in 1931 which was to spread rapidly from one financial centre of Europe to another. The immediate result of this was the abandonment of the gold standard by Great Britain, followed by Sweden, Norway, Denmark, Ireland, Japan and other. A further result was an embargo on gold exports by almost all countries of the world except the United States and France. (The U.S. has since placed an embargo on gold.) Technically and from a world view point these countries have abandoned the gold standard. As a result of the European crises, the gold reserves of the United States were subject to large foreign withdrawals. Almost a year later, in the summer of 1932, the United States suffered another severe gold drainage but was able to meet all demands. This drainage of gold was largely the result of transferring foreign balances from New York to Paris. At this time a technical weakness appeared in the

gold standard system of this country which was temporarily (for a period of one year) remedied by emergency legislation known as the Glass Steagall Bill. The Federal Reserve System of issuing currency was based on the theory that eligible paper would expand during periods of business activity and contract during periods of lesser activity, thereby making an ideal partner for gold as a backing for Federal Reserve currency. This theory assumed that periods of activity necessitated more currency and vice versa, but there has been a new factor enter into the proposition in the greatly increased use of bank checks. There has been a trend to the use of the checking account by the person of small and average means while it was formerly considered as necessary only for those in comfortable financial circumstances. The direct result of this was the lessened need for currency while business was pursuing a normal course. We had a large gold reserve and a plentiful supply of commer-

cial paper which made it seem that our system was extremely sound and there was no agitation for any change. However, the present depression has shown that our system, although sound when inaugurated, has since become obsolete and must be revised. As business receded after 1929, the people of the country still enjoyed a considerable degree of prosperity. While the commercial paper available for rediscount was less, there was still ample coverage for our currency needs. Checking accounts were still active and there was no marked increase in the volume of currency in circulation. As the depression deepened, many people found themselves unable or unwilling to maintain their checking account deposits and reverted to the use of currency for payment of their obligations. Check transactions steadily declined from October 1929 when they reached a peak value of $95,000,000,000 to November 1932 when they totaled $20,000,000,000. Instead of a lessening amount of currency being needed during time of business inactivity, we have the phenomena of a marked increase in its use and during

a period when commercial paper available for rediscount is rapidly contracting. Although we had tremendous gold reserves in 1932, there was such a shortage of commercial paper that legal backing for all new Federal Reserve currency issued required full gold coverage. Each new dollar must be issued on the basis of 100% gold reserve. This technical weakness became most apparent during gold raids on New York in the spring and summer of 1932 and was partially offset by the emergency legislation that has been mentioned. The substance of this legislation was to increase types of credit instruments (Government Bonds) that were eligible for rediscount and currency backing.

In contrast to this constructive legislation that tended to make our system more flexible, was the adoption of a Federal tax of 2% on bank checks as a part of the Emergency Act. Here is the very instrument of credit that is flexible enough to meet all of our needs for a medium of exchange, one that could relieve pressure on currency and

one that should be fostered. The consequence of this tax was to increase the volume of currency needed to carry on business. It also tended to depress prices further through the increased demand for currency, thereby increasing its worth.

Meanwhile our banking system was being seriously undermined and weakened through the drastic lowering of prices. The deposits of 1920-1929 were invested in high priced securities and assets that have since depreciated in value. When the financial crises of 1933 arrived, the banks were called upon to pay depositors in dollars that were far more valuable than those deposited. At the same time there was a flight from the dollar to gold. Gold was demanded for currency and on March 6, 1933, a national bank holiday was declared for a period of four days. The extent of the strain to which our banking system had been subjected may be gained from the following comparison. On Jan 11, 1933, the reserves of the Federal Reserve Bank of New York City in excess of legal requirements were $356,000,000, and on Feb-

ruary 15, 1933, they had been reduced to $29,000,000* which would make it seem probable that excess reserves of that bank were considerably below requirements at the time when the New York State bank holiday was declared on March 4, 1933. On March 1, 1933, the Federal Reserve gold backing for currency was about 55% and although definite information is not available, the figures given above would indicate that there was not sufficient eligible paper and government bonds to make up the additional 45% of coverage for currency in circulation which had reached a new high level for all time at better than seven billion dollars.

The banks need a scaling down of deposits or an increase in the price level to reach solvency, but what is most amazing is that a country whose currency is at a new high level, should still have a 50% backing of gold and find it necessary to abandon redemption of currency and put an embargo on exports of gold.

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*National City Bank of N Y Monthly Letter, Page 37 March 1933

Our monetary system should be so constituted that gold without limit could be used for redemption or at least the reserve limit should be lowered and provision made for increasing the flexibility of the eligible paper volume so that a sufficient supply for currency backing will always be available.

Chapter XII

CONCLUSIONS

Gold is universally the most valuable product known, existing in sufficient quantities for use as a medium of exchange. Granting the truth of the above assertion, gold is the most desireable commodity for this use. There is only one other alternative in creating a medium of exchange and that is currency artificially controlled or valued by governments.

The ideal currency would be one whose value is entirely stable within itself so that all fluctuations in price would reflect increased or lessened demand for goods or services. In this sense gold is not an ideal foundation for our currency and possibly governmental control of currency value can be made to seem ideal, in theory at least.

One favorite argument of those favoring control of currency by artificial means is that we should be able to give value to currency based on

scientific principles without resorting to some metallic substance whose value is determined by chance and fluctuates accordingly.

They, however, presume that the human guidance of "controlled" currency will be wise and prudent. History has shown that currency can best be issued or governed by national governments. If this is true, then we are dependent on our national leaders for this wise and prudent guidance. Even if it be entrusted to a central bank, which may be privately operated, authority thus granted to the central bank may be recalled or revised at the wish or humor of the national government. It means that our "controlled" currency of the future would only be as stable as the party or group in power and nothing is any more changeable in our dynamic world than national governments. No stability of currency over any period of time can be achieved by control vested directly or indirectly in a national government. Gold has had a relatively stable value almost

from the beginning of civilization, while national governments have come and gone. In an ideal state no gold would be needed to effect an exchange of goods, but ideal states do not exist, and in the same way if we had an ideal government, artificial control of currency would be entirely possible and assured of successful operation.

The present breakdown of monetary systems is not due to the inefficiency of the gold standard but to too much interference with the proper operation of the gold standard.

The practical solution to our monetary difficulties lies with the gold standard and its proper operation. What then constitutes proper operation? Principally the free operation of the standard as it existed prior to the World War plus a World Bank that would act as a clearing house for international exchange and a depository for funds of central banks.

This bank should be subscribed to by the central banks of the world. Its relation to these central banks would be similar to the relations of the Federal Reserve Bank to its member banks.

This World Bank would economize the existing gold supply, permit expansion of industrial activities and the development of backward portions of the world, thus raising the standard of living generally. It would have the same effect as a large increase in the world's gold supply. Foreign exchange of subscribing nations would be stabilized and transfer of specie as between countries could be minimized. It would counteract some of the evil effects of high tariffs on international exchange.

The development of the gold exchange standard was an indication of the dependence of the weaker nations on a few strong financial centres for monetary support. This they accomplished by including in the reserves of their central banks foreign exchange of countries with well-developed

This bank should be subscribed to by the central banks of the world. Its relation to these central banks would be similar to the relations of the Federal Reserve Bank to its member banks.

This World Bank would economize the existing gold supply, permit expansion of industrial activities and the development of backward portions of the world, thus raising the standard of living generally. It would have the same effect as a large increase in the world's gold supply. Foreign exchange of subscribing nations would be stabilized and transfer of specie as between countries could be minimized. It would counteract some of the evil effects of high tariffs on international exchange.

The development of the gold exchange standard was an indication of the dependence of the weaker nations on a few strong financial centres for monetary support. This they accomplished by including in the reserves of their central banks foreign exchange of countries with well-developed financial systems whose currency was redeemable in gold. No agreement was necessary to accomplish this as the foreign exchange to be used for reserve purposes could be purchased on the open market. This system was a constant menace to the security of the countries whose foreign exchange was being held as a reserve. When the European banking crisis of 1931 threatened the financial security of England, there was a flight from the pound by countries using English foreign exchange as a reserve. The consequent drain of gold out of England was so great that she was forced to abandon specie payments.

The World Bank should eliminate the necessity for use of the gold exchange standard by the weaker nations. It should inspire confidence in periods of financial stress, and in fact, should be a stabilizing influence to minimize periods of marked financial strain to which we are now subjected. Being international in its character, it should be relatively more stable than any national institution and accordingly a

refuge for surplus gold which could be used to aid the weak nations and thereby maintain a balanced international monetary system. The leveling of the gold supply should keep the value of gold from appreciating to any marked extent in contrast with the experience of the past two years. This bank would be a natural development in view of the extent to which international trade has developed along with industrialism. Nations have become increasingly interdependent and such a bank should be one that would inspire confidence and be a medium that could be used by any country without sacrifice of national pride.

Those nations who found it necessary could use the backing of the World Bank for their currencies. They should be required to make a nominal gold deposit such as 10% of the currency to be issued and the remaining 90% deposit to consist of Government bonds. These bonds should be payable in gold and amortized yearly by payment to the bank. In return the currency of the subscribing nation would be guaranteed. The agree-

ment would provide for withdrawal of guarantee in case of violation of requirements, except that extension of time should be allowed for amortization when a nation is honestly unable to make payment. There should also be a penalty for failure to amortize bonds as they become due even when an extension is granted, so that effort will be made to keep national finances in order.

During the period 1925-1930 when the world as a whole was enjoying unprecedented prosperity, the gold standard was in operation in all of the large and important countries. This is no coincidence but is merely a sample of the prosperity that is ours for the effort of reestablishing the gold standard and in such a way that it will endure.

It has always been true in financial history that new and large sources of gold have brought increased industrial activity and world development. The establishing of an international central bank would have this effect through the efficient use of the world's available gold supply.

Two aids to a better operation of the gold standard for national currencies would be a compulsory lowering of minimum reserve requirements for subscribers to the international bank, or better, redemption of currency until all gold held as reserve has been exhausted, which should tend to prevent runs on national currencies and remove fear that the gold standard will be abandoned when legal reserve percentage can not be maintained as in the United States at present.

International cooperation to an extent that would make this bank possible is entirely possible but there is one menace to the operation of these plans and that is world-wide warfare. War within narrow limits should not seriously threaten its existence, but if the conflict became too wide spread, it might conceivably dissolve the institution. However, once successfully operated, it would be the natural act of resuming peaceful relations to reestablish this bank as soon as possible.

Subscribing nations would have two courses of action for maintaining their currencies on the gold standard. One would be to keep an independent gold reserve upon which the national currency could be based. This course would be followed by the nations strong financially, and their subscription to the World Bank would be principally for convenience in the settlement of international balances and as a depository for surplus gold. The second course of action would be for nations not able to operate an independent financial system and would include many backward and undeveloped nations. For them this bank would offer financial stability and a guarantee of currency as previously outlined in this chapter. The natural result would be increased economic activity that should be of great benefit to all nations. New markets would be available, many new products and industries would be developed and the conomic welfare of people generally would be considerably improved.

The existing Bank of International Settlements functions as an international bank but within much narrower limits than those outlined above. However, its powers could be extended to include the fundamentals of this plan. If this was not feasible, it would be necessary to found an entirely new bank.

These developments imply international cooperation during a period in world history of intense nationalism. However, the fact that this nationalistic attitude has been so strong and has endured for a decade, is a good indication that sentiment may easily swing the other way, particularly because of the severe economic depression through which we are now passing. People have a habit of returning to fundamental truths during periods of adversity.

SUMMARY

The first three chapters of this paper deal with the history and theory of money, and especially as they apply to the use of gold and the gold standard. The evolution of monetary systems and standards is traced through the 19th and 20th centuries with emphasis on the influence of the World War.

In Chapter VIII there is a discussion of some of the difficulties of Federal Reserve banking operations. Chapter IX contains a study of recent English experience with the gold and paper standards as well as the monetary theories of some of our leaders of economic thought.

Some interesting statistics on gold stocks and distribution are contained in Chapter X which deals with the world's gold supply.

A chapter on recent events has been added to this paper due to the interesting monetary

developments in the United States during the past few weeks.

Chapter XII includes not only the conclusions reached as a result of this entire study, but a definite plan of action to remedy the difficulties of maintaining monetary systems in a balanced relation. It is the writer's belief that some plan of international cooperation for the proper operation of an international gold system is nearer than is generally believed.

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